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***Discussion Paper regarding privately-held companies***

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**DISCUSSION PAPER REGARDING PRIVATELY-HELD COMPANIES**

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## A. Introduction.

1. The purpose of this paper is to obtain comments on both general principles and specific points regarding this topic either today or by email after the meeting.

2. The comments are intended for a specific audience: the national and international organizations active in international business as well as the international businesses themselves.

3. The approach of this paper is to first address some general principles relevant to this audience, then to deal with the issues that may be considered for arbitration before giving several practical examples.

## B. Framing the Issue.

*4.* *Arbitration and Mediation*. Two issues are arbitration and other forms of dispute resolution such as mediation. Some view it as essential to treat both at the same time. It is not clear that this is the case.

*5.* *Finality paradox*: the availability of an effective form of compulsory dispute resolution facilitates non-compulsory dispute resolution. Therefore, the first step is to ensure that there is an effective compulsory dispute resolution mechanism, then work on the other methods such as mediation.

*6.* *Arbitration is increasingly accepted in international business*: (1) because the alternative of national courts is viewed as non-neutral, (2) the time for national courts to finally resolve a dispute is longer because of appeals, (3) the national court procedure is rigid and not always suited to business disputes, (4) arbitrators are viewed as more flexible (5) the place of arbitration and therefore the place for annulment proceedings may be in a neutral state, (6) arbitration proceedings are viewed as less costly than common law proceedings at any rate (7) arbitrators may be more flexible in applying the law chosen by the parties and (8) parties can choose the language of the arbitration.

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*7.* *Arbitration is necessary and can be suitable for developing countries*: (1) Usually, financing entities will either insist on national courts of a developed country or arbitration. Arbitration is more neutral for a developing country. (2) Insecurity has an economic cost. However good local judges are, if there is no track record, there will be a cost. The same persons, sitting as arbitrators in an international tribunal will be given added weight. (3) There is increasing internationalization of both arbitration (with the UNCITRAL Model law) and principles of contract (with the UNIDROIT and Vienna Convention on the Sale of Goods principles). (4) The change in attitude in South America over the last 10 years is an excellent example of how national attitudes to arbitration can change.

*8.* *Developing countries object to arbitration on various grounds*. The participants in this meeting will have heard their own reasons for rejecting international arbitration. The ones that I have heard most recently are: (1) The cost of arbitration is greater than that in domestic courts. (2) Arbitrators tend to be from developed countries. (3) The applicable law will frequently be that of a developed country. (4) Developing countries are forced to arbitrate, developed countries use their courts. The underlying concern is that local litigation is a significant advantage for developing countries in case of dispute.

*9.* *Corporate governance involves and interplay of contractual rights, corporate documents and company law in a multiparty setting*. The topic will involve consideration in particular of the corporate documents and the relevant company law relating to a corporate entity. This has to be carried out with reference to economic and organizational rights in a company setting. Many of these aspects have occurred with respect to joint venture agreements, but the topic involves consideration of priorities among these elements in a setting where the arbitral award may well affect a number of shareholders who may or may not be active parties to the arbitration.

*10.* *Key issues*: The key issues appear to be the following: (1) How does arbitration of company/shareholder disputes differ conceptually from that of other disputes. (2) What shareholder rights have to be considered for arbitration and what is the initial reaction to arbitration with respect to such rights. (3) What are the public policy limits on arbitration in general? (4) What are the specific limitations on arbitrability relating to shareholder matters? (5) What are the key procedural differences with respect to such and arbitration? (6) Are there ways in which the law on the merits could be made more accessible or accepted? (7) Are there limitations with respect to the remedies available in international arbitration? (8) How do we ensure that we identify the issues and propose solutions? (9) What are the practical examples that we can point to as to use of arbitration to resolve shareholder disputes?

## C. Particularities of Arbitration of Company Disputes.

11. How does arbitration of shareholder/company disputes differ conceptually from that of other disputes?

12. Arbitration is contractual in nature. Therefore, the usual expectation is that the parties accepting arbitration will be part of a limited group. In the case of certain standard forms, the arbitration clauses have been extended to industries. However, the basic dispute is often bilateral (such as in the shipping or grain trading area).

13. Bilateral investment treaties also provide for arbitration. But the scope of such disputes is limited to investment. (See for example, the definition in the 1991 Bilateral Investment Treaty between the United States and Argentina: "*An investment dispute is a dispute between a Party and a national or company of the other Party arising out of or relating to: a) an investment agreement between that Party and such national or company; b) an investment authorization granted by that*

*Party's foreign investment authority to such national or company; or, c) an alleged breach of any right conferred or created by the Treaty with respect to an investment. (Article VII (1)*))." The focus of such agreements is therefore usually on the inward investment and its conditions rather than on the functioning of the corporate entity.

14. It has also been possible to flow through agreements to arbitrate in various other contracts such as in the construction area. But, frequently the arbitration in itself is limited to one group of companies or one consortium.

15. One of the key limitations on arbitration is that, unlike court proceedings, there is no concept of the necessary and proper party. Therefore, there must be a contractual nexus for the arbitration.

16. More recently, other types of arbitration have been imposed as an alternative forum. The most recent example is the Internet domain name resolution policy. This requires registrants of domain names to accept the dispute resolution but parties retain the right to go to court. Also, in the US securities industry there is optional arbitration of certain securities claims. These examples could be of assistance.

17. Our concern is with international development. But the focus of this paper is on shareholder rights. Assuming that companies created for developing countries obtain international financing, the financing entities will require broad security. In many projects, this security will include the right to take over the shareholder and management position of the private investors. Therefore, if the shareholder rights are the subject of adequate legal protection through arbitration, the financing parties will have the legal security that they need.

18. To try to prepare a scheme to cover creditors as well as shareholders raises serious issues that could prevent acceptance of arbitration. There are various creditors of any company with an international project. They range from international financial institutions to contractors to trade creditors in the country of operation. They will also include various tax authorities in the country of operation. To seek to cover all of these entities would raise substantial complications.

19. What types of shareholder disputes should be subject to arbitration.

20. Arbitration is not "all or nothing" with respect to companies. A company is a legal entity created under a national legal system. Therefore, there will always be a distinction between corporate rights and shareholder rights. The issue is the scope of the arbitration agreement by reference to the rights of a shareholder with the understanding that the remaining rights will be subject to litigation in national courts.

21. Set out below are certain basic examples of rights that may be viewed as appropriate for or not appropriate for arbitration. In each case, the characterization may depend on various policy factors and indeed on the interests of other stakeholders in a company: the employees and the creditors. Note that this list focuses on the rights. It would also be possible to analyze such rights by reference to their source (whether created by a subscription agreement, the corporate documents of the company, the companies' law or general legal principles).

22. One of the basic distinctions with the approach under discussion is with respect to corporate governance. Therefore, in the discussion we should focus in particular on the management issues and the use of arbitration in such contexts.

*23.* *(1) The subscription agreement*. This type of agreement is a classic subject for arbitration. It is in essence a contract. In most systems one could anticipate that arbitration would be acceptable in this area. However, issues may arise as to the scope of the arbitration clause: See *Capital Trust Investment Ltd. v Radio Design AB & Ors* [2002] EWCA Civ 135 (15th February, 2002).

*24.* *(2) Shareholder's financial rights*. These rights relate to issues such as dividends or to obtain the shareholder's share on liquidation of a company or on a "squeeze out" of minority shareholders. This is perhaps less frequent, but is common in joint venture agreements and is found in the Bank for International Settlements arbitration discussed below.

*25.* *(3) Shareholder's rights to information and to participate in corporate activities.* Information is important, especially financial information, as is the right to attend shareholder meetings and the way in which such meetings are conducted. These are dealt with in the joint venture context. In other contexts, frequently these are dealt with by national court proceedings. To the extent that corporate governance is to be dealt with by arbitration, these may well be matters for arbitration.

*26.* *(4) Shareholder's rights regarding ongoing management.* Joint venture agreements, frequently is common to have blocking or management rights that are subject to arbitration. There would appear to be no reason why management rights could not be made subject to arbitration in the international context where the issue is one of control. One of the issues that this raises, however, relates to court-ordered relief limiting management control pending completion of an arbitration regarding management. However, the issue of interim measures and arbitration is common in many other areas of arbitration as well.

*27.* *(5) Appointment of a receiver or liquidator.* The appointment of a receiver is an attempt to either limit or take over the control of a corporate entity. Where this is done at the request of a shareholder, there would appear to be no reason why the issue could not be dealt with by arbitration. Where a receiver and or liquidator is appointed by a company on behalf of creditors, for example, then the potential scope for arbitration is more reduced.

*28.* *(6) Shareholder's derivative rights with respect to management of a company*. The issue of misappropriation of a corporate opportunity or the misuse or transfer of company assets at less than fair market value is a significant area for concern. These are usually dealt with under by national civil or indeed criminal law. Therefore, public policy issues may be particularly relevant to these types of disputes. (In principle these appear to be arbitrable in the United States, see: *In re Salomon Inc. Shareholders' Derivative Litigation* 68 F.3d 554 (2d Cir. 1995)).

*29.* *(7) Shareholder's rights to revive the company*. If a company has been misused, one of the frequent methods of covering up the misuse is simply to liquidate the company. Therefore, the right to revive a company can be a key element of protection for shareholders and creditors. These rights are usually viewed as depending on national law due in particular to the interests of creditors.

30. Public policy limitations on arbitrability.

31. In each relevant country, there must be review the limitations on arbitrability that are imposed generally. For example, in France, there was until recently a limitation on arbitration agreements for future disputes between individuals that did not relate to a commercial matter. This has been changed by statute, but other countries may well have different limits. And for many years, many practitioners questioned whether company statutes could be made the subject of arbitration clauses (although this is now accepted). In parts of the Middle East, there are limitations on the arbitrability of sponsorship or local representation agreements.

32. What are the specific limitations on arbitration of shareholder disputes?

33. National law must be reviewed to determine whether there are other potential conflicts with respect to arbitration of one or more issues regarding shareholder rights. Several basic examples could be given.

34. The companies law will usually impose some sort of restrictions either expressly or implicitly by providing that national courts have the right to decide certain issues.

35. Insolvency law will also impose certain restrictions as the concern will be with other stakeholders in the company.

36. Employment law will also provide certain limitations with respect to arbitration that could affect, for example, the rights of employee shareholders or could affect recourse against management.

37. Procedural issues particular to shareholder arbitration.

38. The basic principle is that arbitration must be accessible and afford due process.

39. If the parties include the company and private investors, there will be an issue as to the costs of the arbitration.

40. With regard to due process, an initial issue is the appointment of the members of the arbitral tribunal. One assumes that this would be done with appointment of all three arbitrators by an arbitral institution or appointing authority.

41. The ongoing issues are similar to those in multiparty arbitration and therefore examples should be reviewed from these areas.

42. Rendering the substantive law more acceptable.

43. The substantive law will usually be the relevant companies' law, the contractual law, the law relating to insolvency, the local accounting law or principles and the local tax law.

44. With respect to the companies' law, there are trends within the EU to harmonize legislation. Since this legislation has in turn influenced legislation elsewhere, this could be part of a trend. However, it is not clear that it will come about without a real initiative on the issue.

45. As regards the contractual principles, the UNIDROIT principles are arguably gaining more acceptance (as is the Vienna Convention). The fact that these principles are viewed as more neutral is of assistance. Lawyers from certain countries have objected to arbitration because they are not familiar with the substantive law and it is not accessible or accessible at reasonable cost. This issue can be reduced in some circumstances.

46. With regard to insolvency law, there is of course a trend to harmonization in the EU, but it is not clear that the principles will be the same elsewhere. In fact, depending on the scope for arbitration, this issue may not be as important.

47. Limitations on remedies.

48. Remedies have to be effective for arbitration to work. The basic principle is of course that enforcement will usually depend on the national courts of the place where the company is incorporated or has its principal place of business, although this need not be the case in all instances. For example, in some cases it may be possible to have the shareholders' register maintained outside the country. In addition, depending on the place of arbitration and the countries involved, the New York convention should provide assistance.

49. In many of these disputes, interim measures are sought. Therefore, there will be an issue as to how these interim measures can be dealt with without undermining the overall arbitrability. For example, if one group can appoint a receiver for a company or otherwise limit management pending arbitration, then the effectiveness of the arbitration provision may be adversely affected. Indeed, this type of provision may trigger a default under financing covenants and thus detrimentally affect the entire company unless there is a rapid, effective procedure for dealing with the situation.

50. The remedies could also be rendered effective by requiring the company to abide by certain decisions as a form of automatic interim relief. (There is a similarity with domain name proceedings and with certain construction proceedings in this respect.)

51. Identifying the Issues and Proposing Solutions.

52. Arbitration of shareholder disputes involves several different areas of law. It involves the interaction of national law and arbitration rules. It also requires a certain analysis of exactly how important the issue is perceived to be by certain entities involved in international development.

53. One possible way forward would be to prepare a detailed questionnaire and to ask for brief national reports on the various aspects referred to above. This type of research should be aimed at countries at various stages of economic development. The purpose would be to determine whether there is a need to develop this type of arbitration and if so whether there are procedural or substantive issues that should be reviewed to develop this type of arbitration.

54. In beginning this research, it may be helpful to refer to several practical examples of the use of arbitration in the context of shareholder disputes.

**D. What is the experience with arbitration?**

55. Institutional experience. It would be of interest to know what the arbitration institutions have had as experience with respect to arbitration of these types of disputes and whether particular difficulties have arisen.

56. Joint venture or consortium disputes. A great number of these disputes provide for arbitration of disputes. But these are particular due to the limited number of participants. Moreover, because there was no accepted procedure for arbitration of corporate governance disputes, in some cases there have been two tiers of legality. The large companies have contractual rights that are subject to arbitration. And the participants have additional rights (assumed by some to be subsidiary in nature) under the companies law of the place of incorporation.

57. Joint venture regarding automobile production. (Developing and developed country) The issue evolved around the control of the company which was subject to arbitration and the appointment of the key management official. Recourse to the courts would have basically precluded a time-effective resolution of the dispute as the courts of the country involved are notoriously slow. Note that the company law was similar to English law. The developing country involved has adopted the

UNCITRAL Model law and the New York Convention. The dispute was settled during the arbitration.

58. Joint venture regarding distribution. (Developed country and wealthy developing country) The joint venture agreement is subject to civil law. The corporate entity is subject to an English-based companies act. One of the potential issues is the conflict if any between the governing law of the joint venture agreement and the company law.

59. Joint venture in telecommunications (American and European companies). This was reviewed prior to any dispute (and when the parties disagreed they eventually settled the dispute). The key factor for the corporate lawyers was the precedence and potential conflict between the joint venture agreement and the statutes (or articles of association and by-laws of the company). The concern was that the joint venture agreement (with international arbitration) would be effectively undone by interim measures in the national court of the other party.

60. Bank for International Settlements Arbitration.

61. A number of the issues that are mentioned have been or are being dealt with within the context of the BIS arbitration, which is an example of arbitration used by developed countries. The BIS Agreement was signed on January 20, 1930. The BIS was created by convention (therefore no applicable companies' law). The parties made it clear that the BIS was not subject to Swiss law, but does not exclude the use of Swiss law for formalities where there is no conflict with international law. Therefore, the law applicable to the BIS was "lex specialis" and not the company law of one country.

62. The BIS Shares did not provide voting or representation rights at the General Meeting. The BIS was intended for central banks. Some central banks could not subscribe at the time. A substantial number of shares were held by private individuals. Shares were traded in Paris and Zurich. BIS held an Extraordinary General Meeting in January 2001 to amend the Statutes to exclude private shareholders. The issue was therefore an amendment of the corporate documents.

63. The BIS Statutes provided for arbitration of disputes. Private shareholders invoked arbitration. Five arbitrators were appointed. The chairman is American. Two are nationals of states that were neutral in the First World War. One to be German and one is to be a national of one of the powers which are creditors of Germany. Therefore, the panel was external to the parties.

64. One claimant brought proceedings regarding the amount of compensation to be paid. Another sought to inspect the Registry without first filing a notice of arbitration. Another claimant objected to the forced repurchase of shares at all. The claimants' interests varied from 9,085 shares to 8 shares. In the procedural order, the Bank deposited one half of the allocation of the costs and deposits for arbitrators. Each claimant was to deposit his *pro rata* share of the remaining half of the costs of the arbitration. It is not clear how accessible this procedure was.

65. There was an agreed procedure. And notice of potential claims given to other shareholders on the website. Note that various issues relating to discovery were raised, in particular relating to prior transactions regarding the shares. Issues also arose as to privileged documents. It is not clear what the limits on res judicata would be in such circumstances, hence perhaps the notice and publication of documents on the web site.

66. Substantive arguments were made as to the method of valuation. The Tribunal relied on international law standards and case law and arbitration practice of the US-Iranian Claims Tribunal particularly as regards valuation. The Tribunal held that the proportionate share of the net asset value

is the method required by the relevant documents and that in accordance with prior practice it was to be discounted by 30%.

67. The BIS filed a counterclaim because one of the claimants had brought US proceedings to avoid arbitration. However, the Tribunal found that there was insufficient evidence as to the amount. (The case went to the US Second Circuit Court of Appeal that rejected a temporary restraining order based on the failure to demonstrate irremedial harm.)

68. The BIS arbitration is quite specific. But it is interesting that a number of the basic issues that we are proposing to deal with regarding arbitration of company disputes have been dealt with quite recently.

**E. Conclusion.**

69. International arbitration has expanded because of neutrality in an international setting. It is accepted by international financial institutions and businesses because it has a proven track record. It could be expanded into the company law area but to do so will require adapting it to the particular requirements in this area.

70. The first issue is whether the general principles referred to above justify further review regarding the use of arbitration in the shareholder setting. Assuming that they do, and subject to the comments on these general principles a more detailed analysis is required to try to deal with the specific problems with such form of arbitration to try to anticipate the problems in this area.